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Euro at 20 – Success or…
International Economics Series

Today Europe finds itself at the 20-year anniversary of the introduction of the euro, marking a time to reflect on its successes and future challenges. The euro is the culmination of decades of previous political and economic integration of Europe, which might be dated back to the Bretton Woods agreement in 1944. This agreement established a system in which currencies were pegged to the U.S. dollar, which was pegged to the price of gold. In the 1960s financial integration and capital mobility in Europe rendered these "fixed but adjustable" exchange rate pegs difficult to manage. Western Europe needed fixed exchange rates to avoid destabilization as they embarked on closer economic integration. Repeated attempts to stabilize intra-European exchange rates failed, leading countries to seek alternative options.

By the 1990s Europeans were realizing that a common economic market needed a common currency to improve competitiveness across countries. There were also political motivations for moving towards a common currency after the reunification of Germany. The creation of the euro and the European Central Bank (ECB) allowed Europe to avoid the de facto anchor role of Germany's Bundesbank.

The European Monetary Union (EMU) was established in 1999. Since its original implementation, Europe has seen an increase in stability and a reduction in exchange rate volatility. They accomplished this by eliminating exchange rate variations within the euro area and offering a stable international means of payment. The ECB has only one target, which is price stability. This differs from other central banks such as the Federal Reserve in the United States, which has dual targets of price stability and full employment. For the purposes of the ECB, "price stability" means an inflation rate not above but close to 2%. The goal is not a 0% inflation rate because it would create a greater risk of deflation.

Since 1999, more countries have been admitted to the EMU, with Lithuania being the latest country to join in 2015. In some cases, political factors were central to countries' admission to the Eurozone. For example, though Greece was not fully ready to join the EMU in 2001, they were still admitted to bring a young democracy with a strategic position into the European fold. The Maastricht criteria, which outline the requirements to join the Eurozone, have not been sufficient as there was not enough emphasis on the long-term viability of a country as an EMU member. Today the ECB has learned to be more cautious when granting membership.

While the global financial crisis began in the U.S. with the collapse of Lehman Brothers, it has proved more toxic and sustained in Europe. The crisis caused huge strains on public finances and interest rates for government bonds soared. Bailouts of debt-laden member states caused market skepticism of the viability of the euro, exacerbating the problem. In 2012, ECB president Mario Draghi made the now-famous remark that the ECB was ready to do “whatever it takes” to preserve the euro, in an attempt to calm the concerns of investors. In the wake of the crisis the ECB announced that it was prepared to buy government bonds if that would restore trust in the European monetary system. Though this program was never implemented, this announcement was enough to calm investors and decrease bond yields across the EMU.

There are large differences between the ECB and the U.S. Federal Reserve that may give the U.S. some advantages over countries in Europe. For example, the U.S. can avoid going bankrupt because Congress can simply raise the debt ceiling and, if necessary, print money. However, in the European system, individual countries can theoretically go into bankruptcy, which means they are more controlled by capital markets.

The economic landscape for the euro has undergone significant changes in recent years. There has been a decline in the natural rate of interest and prolonged period of very low nominal interest rates that can have a negative effect on financial and economic stability. Even with implementation of unconventional monetary policies, it has become increasingly difficult to steer inflation expectations, giving governments reason to reflect on their strategy, tools and communications.

Though there are still significant challenges to face, in the last 10 years Europe has achieved greater stability than ever. The ECB has followed expansionary policy to overcome financial challenges and avoid deflation. Today over 60 countries are either using the euro, link their currency to the euro, or have plans to use it; indeed, the euro has quickly become one of the most important global currencies. While the financial crisis and other unexpected disturbances have presented challenges over the last 20 years, overall the creation and implementation of the euro has been a success story.